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SOCIALLY RESPONSIBLE INVESTING: IS SHARIAH INVESTING A VIABLE ALTERNATIVE?

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ABSTRACT

Purpose – Socially responsible investing (SRI) and Shariah investing have been two of the most demanding areas of finance over the last two decades. Ethics have captured the intention of the investors which there are some investors want to seek profits through their investments and at the same time perform their moral duty toward the society. Since investors become more aware of the benefits of ethics and socially responsible investment, there are increasing demands in Shariah investing and ethically based banking. Fortunately, for non-Muslim investors, Shariah investing can be seen as a viable alternative of ethical investing. Instead of focusing in the social values, Shariah investing also promises the same performance, added up with a strong risk management framework. Hence, this study seeks to explain in detail about the similarities between Socially Responsible Investing (SRI) and Shariah investing. Besides that, this study also focuses to compare the differences between Socially Responsible Investing (SRI) and Shariah investing. Last but not least, this study attempts to identify the viability of Shariah investing as an alternative to Socially Responsible Investing (SRI).

KEYWORDS: SRI, Shariah, Ethics.

1. INTRODUCTION

The relationship between the investors and wealth creation cannot be separated. The investment decisions are only focuses on the risk and returns by aiming the profit maximization as the main goal. But, over the last few years many investors have the interest into the investment that aligns with the social responsibility attached to their investment portfolios. Socially Responsible Investing (SRI) provides opportunity to the investors by investing their money parallel with their core beliefs in promoting social good instead of having only good financial return (Kamso, 2013). SRI is also known as ethical investment that not only gives benefit to humanity but also to the environmental aspect.

In this forthcoming, the corporate world are more concern towards social awareness and able to see concretely that their investment style should congruent with the ethical values. Investing either in SRI or Shariah investing, it will be the most effective and efficient ways to solve today's economic challenges. The investors have to avoid the myths because investing in both types of ethical investment does not mean the return is lower compared to the conventional counterparts. In fact, there are rising number of investors who have the attention to invest through an ethical and socially responsible investment which align with their principles and beliefs. Statistically, the year of 2011 shows the demand towards socially responsible or ethical investments is increase. Meanwhile, Greenamerica.org reported that about 85 percent of their clients have interest to invest in more socially responsible investment for their portfolios. According to EUROSIF (2012), the growth of SRI shows there is no slowing sign and it can be concluded that the European asset management industry is continuing to support sustainable investment in their financial field.

However, for those who are the ethical investors, Shariah investing can be seen as a viable alternative of ethical investing. Indeed, there are very little differences between investing in ethical and Shariah investments. The differences can be seen through the base of Shariah investment itself which is more focus on structures and faith-endorsed process, yet at the end grants close to similar outcomes. According to Shariah Investing reports (2009), in the event of credit crisis Shariah Indices have a very good performance compared to their conventional counterparts. The MSCI World Islamic Index has better track record with lower volatility than the MSCI World Index during the crisis. It shows that Shariah investing is not only has good performance in volatile times or during the crisis but its performance across a full market cycle where the SRI cannot survive in that particular time. In fact, McKinsey Islamic World Conference (2008 – 2009) report stated between 10 and 20 percent of the high-net-worth individuals were ready to invest in Shariah investing. According to this, it provides a reasonable market demand to drive the development and expansion of Shariah compliant investment products and solutions.

2. LITERATURE REVIEW

A study conducted by Renneboog et al. (2008) defined ethical investments require a process which coordinates the elements of social, environmental and ethical considerations into the investment decisions. According to Cowton (1994), ethical investment represents a distinct investment option which relies on ethical values to be implemented into the investment portfolio. Ethical investors will take consideration on the attribute of the company's products, the location where it's set up the business and the ways it conducts its affairs. A screening process implemented in an ethical investment in order to assess that the companies' involvement in the investment activities meet their ethical policy. In fact, ethical investing has its origins in religions such as Judaism, Christianity as well as Islam. According to Emelki and Ben (2009), Judaism and Christianity originally have teachings and there are ethical restrictions on how to use money, loans as well as investments.

According to Reenboog et al. (2008), in contrast to these ancient traditions of ethical investing, the modern SRI is now based on personal values and social convictions of the individual investors. The issues like anti-war, anti-racist movements, environmental protection, human rights and labour relations are issues that are focused in the SRI investment screening process.

On the other hand, the Shariah investing which is also known as the Shariah compliant investment represents a unique category of the ethical investment (Atta, 2000). The investments must be free from the elements of riba (interest), gharar (uncertainty), and maysir (gambling) that lead in exploitation and injustice. According to Rosylin et al. (2010), Shariah investing also prohibits investments in companies that produce goods that have been scientifically proven to result in damage and gives harm to health such as alcohol, tobacco, and pork-related products.

In detail, the fundamental sources of Islam which are the Qur'an and the Sunnah do not approve the implementation of interest (riba) and Islam condemn about it. The condemnation of interest was clearly stated it the verse Al-Baqarah: 275,

وأحل الله البيع وحرم الربا

"…But Allah has permitted exchange and has forbidden usury…"

There are also a number of narrations from the Sunnah on the prohibition of riba. From Jabir, he narrated that:

> *"The Prophet S.A.W. cursed the receiver and the payer of interest (riba), the one who records it and the two witnesses to the transactions; and said:" They are all alike (in guilt)."*

The Prophet S.A.W prohibits the conduct of riba because it eliminates exploitation in business transactions. There is another narration that come from Ibnu Mas'ud (RA), he narrated that the Prophet SAW said:

> *"There are seventy three different types of riba, the least of which is equivalent (in sin)to committing incest, and the worst of which is equivalent (in sin) to destroying the honor of aMuslim."*

From this Sunnah, it can be concluded that as a Muslim, it is compulsory to avoid the activities that involve with the elements of interest. Hence, the beauty of Islam can be seen through the permissibility of Islam to the Muslim or non-Muslim to appreciate and enjoy healthy of Shariah investing.

3. FINDINGS

3.1 The Similarities between Socially Responsible Investing (SRI) and Shariah Investing

In this forthcoming, the corporate world are more concern towards social awareness and able to see concretely that their investment style should congruent with the ethical values. There are rising number of investors who has the interest to invest through ethical and socially responsible investment to ensure it parallel with their principles.

According to Kamso (2013), the commonality between SRI and Shariah investing are both SRI and Shariah investing are focused principally on individuals using their money in a manner that conforms to their morals and beliefs. Traditionally, in finance the investors are driven solely by the effort to maximize risk adjusted returns but in SRI and Shariah investing, the investors have added an additional objective for financial market activity compatible with their ethics and promotion of social-welfare activities. Instead of aiming the profit maximization, the investors are also aware to the social returns that the society will received from their money. In this forthcoming, the growth of both SRI and Shariah investing has been largely demanded, with financial institution concentrate for more resources to these two areas in response to the increasing demand from individual investor clients for these products.

3.2 Socially Responsible Investing (SRI) Versus Shariah Investing

Instead of having commonalities, there are few differences between SRI and Shariah investing. Shariah investing is based on the Islamic principles and there are restrictions on the investment to be transacted. Kamso (2013) concluded that the differences can be seen through the aspects of core values, screening criteria and practice of interest.

3.2.1 Core Values

The core value in SRI is focuses on human being, environmental and social values. While in Shariah investing based on religious principles that include all values covered in SRI. Accordingly, if an investor is deemed comfortable with investing in SRI, the same investor will naturally become comfortable investing in Shariah funds. Technically, it means investing in more financially stable companies considering that the financial ratios for the screening of Shariah companies is a step forward compared to the ethical screening because it ensures that the Shariah companies are low-leveraged, well-managed companies with limited downsides in a down-trending market. This means there is a quantitative risk overlay embedded in the equity investment process of a Shariah portfolio.

3.2.2 Screening Process

SRI used a screening process to ensure that the companies they invest are the right ones to meet their ethical policy. The screening will remove companies considered to be negative and will encourage investment in "positive" companies. According to the Ethical Investment Association of Australia, the ways of investing ethically are avoiding some types of investments for examples gambling companies and weapons manufacturers. It more focuses to the future-oriented industries such as renewable energy and health care.

Differ from Shariah screening process which is more specific consists of the two screening categories: qualitative approach and quantitative approach. Under the qualitative approach companies will be classified as Shariah non-compliant securities if they are involved in the following core activities such as financial services based on interest, gambling and gaming, manufacture or sale of non-halal products or related products, conventional insurance, entertainment activities that are non-permissible according to Shariah, manufacture or sale of tobacco-based products, stockbroking or share trading in Shariah non-compliant securities and other activities deemed non-permissible according to Shariah.

In addition, started in November 2013, the Securities Commission Malaysia had released a revised activity-based benchmark for the quantitative approach. Securities Commission (SC) adopted a 2-tier quantitative approach measuring: 1) the business activity benchmark which cannot exceed 5% or 20% of companies' exposure to certain businesses, and 2) the financial ratio benchmark, where the cash/ debt over total assets that are not in Islamic accounts and financing cannot exceed 33%.

3.2.3 Practice of Riba (interest)

Shariah investing prohibits the implementation of interest, uncertainty and gambling in any transaction, whereas SRI practices it as their core business transaction. The prohibition of interest is the pillar of the Islamic economy. This prohibition is to protect the social justice, equality and property rights. According to the Islamic view, interest violates the principle of social justice because it rewards people who neither make an effort nor participate in the risks of the projects financed.

The Holy Qur'an prohibits the charging and the payment of interest. Technically, Riba (interest) refers to the addition in the amount of the principal of a loan according to the time for which it is loaned with the amount of the loan. Islam is not against the earning of money, but it prohibits the earning of money through unfair trading practices and other socially harmful activities. Islam seeks to build up an economic environment based on fairness and justice through the prohibition of interest.

3.3 Is Shariah Investing a Viable Alternative?

All the socially responsible investors either Muslim or non-Muslim can choose investments that are parallel with their value systems and beliefs without being doubtful that it leads to the inferior performance or expose to higher systematic risk. During the crisis periods in major markets, the performance of Shariah investing remains resilient compared to SRI. It shows that Shariah investing is a viable alternative in term of ethical investment. The relevance of the Shariah investing can be seen through its performance, volatility in the systematic risk and Sukuk which make it suit very well for the socially responsible investors.

3.3.1 Performance

Hussein (2005) concluded that Shariah screening process does not affect to give low return to the investors. According to Wilson (2001) and Ahmad (2001), Islamic mutual funds are financially viable and Shariah compliant investments can compete on a commercial risk and return basis. Interestingly, the study conducted by Merdad et al. (2010) that showed Shariah investing is a viable alternative during the credit crisis. This study investigates the performance of the SRI and Shariah investing in the bull and bear period and indicates that during full and bullish periods, the Islamic mutual funds managed by HSBC in Saudi Arabia tend to underperform against their SRI counterparts. But during bearish and financial crisis period the Shariah investing is outperform the conventional funds. This finding is supported by Kamso (2013) summarized that Shariah investing do not promise a complete immunity against future black swans but it is a viable alternative. It certainly offers lower volatility than some of their conventional counterparts over the long term.

3.3.2 Systematic Risk

According to Ohad et al. (2012), the systematic risk is defined as the risk inherent to the entire market or an entire market segment. This type of risk is unpredictable and impossible to completely avoid. Besides, it cannot be mitigated through diversification, but through hedging or by using the right asset allocation strategy. Saeed and Kabir

(2013) concluded that Shariah investing tend to be less volatile to the systematic risk compared to the conventional portfolios. This is supported by Abdullah et al. (2007) and Muhammad and Mokhtar (2008) summarized that Malaysian Islamic funds are less sensitive to the market volatility compared to their conventional counterpart funds and indicate that Shariah investing is less exposure to the systematic risk.

According to Hakim and Rashidian (2004) showed that the US Dow Jones Islamic Index seems to be less sensitive to the volatility in systematic risk than their conventional counterpart indices. Besides that, a study conducted by Al-Zoubi and Maghyereh (2007) also give the same finding which indicates less risk associated with the Dow Jones Islamic Market Index (DJIM) compared to the Dow Jones World Index (DJW). Thus, the similar result disclosed by Albaity and Ahmad (2008) in their study on the Kuala Lumpur Syariah Index (KLSI) and Kuala Lumpur Composite Index (KLCI). In their research, it can be concluded that KLSI is less risky than KLCI.

3.3.3 Sukuk (Islamic bond)

Bond can be defined as a certificate that represents ownership of an asset of a company to conduct the investment. Sukuk (Islamic bond) is one of the Shariah compliant products that are closer to the non-Muslim SRI investors where it financing is used to develop a specific sustainable development project. Sukuk differ from the conventional bond offered in the market. Sukuk are suitable to serve as a bridge product between Islamic finance and conventional finance for a several reasons (Michael and Zamir, 2013). Sukuk is designed to involve with the rigorous process of structuring. Each of the proposed Sukuk must be reviewed by the Shariah scholars to ensure that the tenets of Islam are not being breach in any way. This process is important for Sukuk in order not to finance any activities that might give harm to the society. Thus, the Sukuk structuring process can be seen as an added value to capture the interest of SRI investors due to the diligence process.

In addition, Sukuk are backed by real assets which can be divided into two: Asset-Based and Asset-Backed. According to Kamso (2013), there is underlying asset in every transaction and the ownership of the asset is transferred to the investors.

investors can enjoy all rights and obligations that accompany ownership. While in the asset-backed structures, Sukuk holders have recourse to the underlying assets. According to Michael and Zamir (2013), Sukuk are appropriate for SRI investors because Sukuk promises a high degree of certainty that their money will be used for a beneficial purpose. Besides, the transactions must be free from the element of uncertainty while the terms and conditions must be clearly defined. According to Dato' Dr. Nik Ramlah Nik Mahmood (Managing Director, Securities Commission Malaysia), Malaysia also maintained the position as the largest sukuk issuer in the world, accounting for 69% of the global sukuk issuance

4 CONCLUSION AND RECOMMENDATION

In this forthcoming, the corporate world are more concern towards social awareness and able to see concretely that their investment style should congruent with the ethical values. For the ethical investors, Shariah investing can be seen as the best option of ethical investing. The investors have to avoid the myths because the truth is investing in the Shariah investment does not mean the return is lower compared to the conventional counterparts. It has been proven that Shariah screening criteria do not contribute to the lower performance of investment.

Furthermore, during the credit crisis, Shariah investing portfolios tend to be less sensitive to the systematic risk rather than the conventional counterparts. For the investors, this is the best choice of investment since this type of risk is unpredictable and impossible to completely avoid. Moreover, during the crisis periods in major markets or the black swan event, the performance of Shariah investing remains resilient compared to SRI. The effect from the global financial crisis in 2008 dragged the banking regulatory to a reformation. The ability of Shariah investing to be resilient over this period is because it supported by good risk management framework through the Shariah financial screening at the portfolio levelitself.

Interestingly, Shariah investing is also provides an avenue to the investors especially to small and individual ethical investors. Shariah investing seems to be more exposed to small and growth companies. It shows that Shariah investing is a viable alternative for the investors either Muslim or non-Muslim to invest. Despite of that, the existence of Sukuk which acts as a bridge between Shariah Investing and SRI raise a new phenomenon in the capital market. The unique features of Sukuk through the rigorous process of structuring, backed by real assets, provides a high degree of certainty and remains its resilience during the world financial crisis shows Sukuk is the worth investment for SRI investors to think about.

Thus, there are some recommendations that the Islamic finance industry can be successfully emerge in the conventional systems and attract all the non-Muslim investors to invest in the Shariah funds. The speed and degree of success are depending on whether potential depositors and investors are well informed about the opportunities and risks at hand. Consumers should be duly informed of all the risks they run when entering into new contracts, as they will have a better understanding of Shariah contract. It is also depend on whether Shariah investing is perceived as a transparent and well-regulated activity.

In consequence, regulators should also encourage the institutions that offering Islamic products to actively pursue awareness campaigns and implement a high disclosure and transparency standards such as the Transparency and Market Discipline Standard prepared by the IFSB. In practice, these tasks can be easily accomplished by simply providing an explanatory prospectus to interested customers.

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